

## Message Text

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PASS TREAS FOR PARSKY AND WIDMAN, EB/IFD/OMA FOR RYAN

E.O.11652: N/A

TAGS: EFIN, OECD, EINV, ENRG

SUBJECT: PAPERS FOR IEA AD HOC GROUP ON FINANCIAL AND  
INVESTMENT ISSUES (FII): PART I (PAPER ON  
ANALYSIS OF THE WORLD ECONOMIC SITUATION)

REFS: (A) OECD PARIS 5996

(B) OECD PARIS 5872

(C) STATE 55605

1. MISSION HAS BEGUN RECEIVING FROM SECRETARIAT PRELIMINARY DRAFTS OF "COMMENT OR POSITION" PAPERS, IN ACCORDANCE WITH ASSIGNMENT OF RESPONSIBILITIES MADE AT LAST MEETING OF IEA GOVERNING BOARD AND OF AD HOC GROUP ON FINANCIAL AND INVESTMENT ISSUES ON MARCH 6 (REFTEL A). INDIVIDUAL POSITION PAPERS WILL BE TRANSMITTED BY SEPARATE CABLES

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2. THIS CABLE TRANSMITS THE FOLLOWING PAPER ENTITLED, "ANALYSIS OF THE WORLD ECONOMIC SITUATION," WHICH CORRESPONDS TO ITEM I OF THE TABLE CONTAINED IN DOCUMENT IEA/SPC(75)7 SECOND REVISION, CITED IN REFTEL A.

BEGIN TEXT

I. ANALYSIS OF THE WORLD ECONOMIC SITUATION

1. THE FOLLOWING PAPER SUMMARISES THE MAIN SHORT AND MEDIUM TERM EFFECTS OF THE OIL PRICE RISE ON THE WORLD ECONOMY AND IN PARTICULAR ON DEMAND AND OUTPUT AND WORLD TRADE. THE INFLATIONARY IMPACT AND THE RELATED POLICY ISSUES ARE DISCUSSED IN A SEPARATE PAPER.

I. SHORT TERM

2. IT IS TECHNICALLY IMPOSSIBLE TO QUANTIFY, WITH ANY PRECISION THE EFFECTS OF THE 1973-74 DEVELOPMENTS IN THE OIL MARKET ON DEMAND, OUTPUT AND TRADE. CYCLICAL DEVELOPMENTS INDEPENDENT OF THE OIL MARKET SITUATION WERE, SIMULTANEOUSLY, EXERCISING POWERFUL EFFECTS.

3. NONETHELESS, IT SEEMS IMPORTANT TO HAVE A CLEAR VIEW OF THE MECHANISMS THROUGH WHICH THE OIL PRICE-INCREASE HAS AFFECTED THE OECD ECONOMIES, AND TO ARRIVE AT SOME APPROXIMATE IDEAS OF THE MAGNITUDES OF THE OIL EFFECTS. THE LATTER MAY HAVE BEEN EXAGGERATED IN SOME COMMUNITIES - BUT SYSTEMATICALLY MINIMIZED IN OTHERS.

4. THE MASSIVE OIL PRICE-RISE TRANSFERRED INCOME FROM OECD RESIDENTS TO OIL-PRODUCING COUNTRIES WITH A MUCH HIGHER MARGINAL SAVINGS RATIO. THIS DIRECT CONTRACTIONARY EFFECT OF UNSPENT OPEC OIL REVENUES IN 1974 REPRESENTED SOME 1-1/2 PERCENT OF EFFECTIVE DEMAND IN THE OECD. BUT THIS CONTRACTIONARY INFLUENCE WAS TEMPORARILY MASKED, IN EARLY 1974, BY THE FACT THAT ECONOMIC AGENTS FIRST PERCEIVED THE COST-RAISING EFFECT OF THE OPEC DECISIONS. FORESEEING THIS - AND THE SIMILAR LIMITED OFFICIAL USE

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EFFECT BUILDING UP FROM THE RISE IN OTHER COMMODITY PRICES - HOUSEHOLDS AND FIRMS TRIED "TO BEAT THE INFLATION" BY BUILDING UP STOCKS AT OLD PRICES (OR CLINGING TO THEM UNTIL PRICES WERE ALLOWED TO RISE) AND MORE GENERALLY BY ANTICIPATORY PURCHASES. THIS BEHAVIOR HAS GIVEN A TEMPORARY FILLIP TO DEMAND AND EXACERBATED PRICE INCREASES, NOTABLY IN THE COMMODITY MARKETS.

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5. THE PARTICULARLY SHARP RATE OF INFLATION OF EARLY-1974 INDUCED MANY GOVERNMENTS TO GO BEYOND THE ACTION WHICH THEY HAD TAKEN IN 1973 TO CURB AGGREGATE DEMAND; AND IN SOME CASES BALANCE-OF-PAYMENT WORRIES, EXACERBATED BY THE PRICE OF OIL, PROVIDED AN ADDED INDUCEMENT. AS A RESULT, THE MIDDLE OF 1974 ONWARDS SAW THE LEVEL OF ACTIVITY BEING CONTRACTED, SIMULTANEOUSLY, BY THE EFFECTS OF DEMAND-MANAGEMENT, THE SPONTANEOUS DECELERATION OF THE BOOM AS SPECULATIVE STOCK BUILDING BEGAN TO BE UNWOUND, AND THE CONTRACTIONARY EFFECT OF THE SHIFT OF INCOME FROM OECD TO OPEC COUNTRIES.

6. ANOTHER POSSIBLE WAY OF MAKING SOME ASSESSMENT OF THE MACRO-ECONOMIC EFFECTS OF THE OIL CRISIS IS TO COMPARE THE FORECASTS MADE IN OCTOBER 1973, BEFORE THE CRISIS,

WITH THE ACTUAL OUTCOME. COMPARED WITH THE IMMEDIATE  
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PRE-CRISIS FORECAST OF A REAL GROWTH OF 4 PERCENT, GNP  
IN THE OECD AREA IS NOW THOUGHT TO HAVE FALLEN IN 1974  
BY NEARLY 1/2 PERCENT. IN 1975 GNP SEEMS LIKELY TO FALL,  
AGAIN, BY AROUND 1 PERCENT. THIS WOULD MEAN AN ACTUAL  
1975 GNP THAT FALLS SHORT OF POTENTIAL BY SOME 11 PER-  
CENT, OR MORE THAN 2 YEARS "NORMAL" GROWTH OF REAL  
CONSUMPTION AND INVESTMENT.

7. APART FROM THEIR SOMEWHAT DELAYED GLOBAL DEFLATIONARY  
IMPACT, THE OIL PRICE RISE AND SUPPLY UNCERTAINTIES HAD  
IMMEDIATE AND MORE SPECTACULAR REPERCUSSIONS ON THE  
PATTERN OF DEMAND. PARTICULARLY HARD HIT WERE THE CAR  
INDUSTRY, AIR TRANSPORT, TOURISM AND LEISURE INDUSTRIES.  
IT IS PRACTICALLY IMPOSSIBLE TO DISENTANGLE THE GASOLINE  
PRICE EFFECT ON CAR DEMAND FROM THE IMPACT OF REDUCED  
OVERALL DEMAND AND A POSSIBLE CHANGE IN CONSUMER HABITS.  
IN ANY CASE, THE CAR SLUMP HAS FURTHER DEEPEENED THE  
GENERAL RECESSION BECAUSE OF THE LARGE MULTIPLIER ASSO-  
CIATED WITH THE AUTOMOTIVE INDUSTRY.

8. THE SHORT-TERM EFFECTS OF THE OIL PRICE INCREASE ON  
INTERNATIONAL TRADE CANNOT BE SEPARATED FROM THE OVERALL  
IMPACT OF COST INFLATION AND DEPRESSED REAL DEMAND IN  
THE OECD AREA. INSTEAD OF RISING BY 10-1/2 PERCENT AS  
EXPECTED IN OCTOBER 1973, THE VOLUME OF OECD IMPORTS  
PROBABLY INCREASED BY ONLY 2 PERCENT IN 1974(1) AND THE  
PROSPECT IS FOR CONTINUED STAGNATION IN 1975. OECD  
EXPORTS, WHICH WERE FORECAST TO RISE IN REAL TERMS BY  
11 PERCENT IN 1974, HAVE ONLY EXPANDED BY PERHAPS 8 PER-  
CENT AS DEMAND FROM OPEC AND NON-OIL LDCS SURGED, BUT  
INTRA-OECD TRADE DECLINED SIGNIFICANTLY. WITH THE WEAK-  
ENING OF DEMAND FROM NON-OIL LDCS IN THE WAKE OF FALLING  
EXPORT REVENUES, LITTLE GROWTH IN TOTAL OECD EXPORT  
VOLUMES CAN BE EXPECTED IN 1975.

(FOOTNOTE (L): IT SHOULD BE NOTED THAT THE REDUCTION IN  
THE VOLUME OF OIL IMPORTS BY SOME 3-1/2 PERCENT  
ACCOUNTS FOR ONLY A SMALL FRACTION OF THE DECELERATION  
IN TOTAL OECD IMPORTS.)

9. THE PICTURE IN CURRENT VALUE TERMS WAS QUITE DIFFER-  
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ENT. LED BY OIL AND OTHER COMMODITIES, OECD IMPORT PRICES EXPRESSED IN NATIONAL CURRENCIES ROSE BY MORE THAN TWO-FIFTHS IN 1974, WHEREAS EXPORT PRICES ROSE BY SLIGHTLY MORE THAN A QUARTER. (PRIOR TO THE ENERGY CRISIS, BOTH IMPORT AND EXPORT PRICES WERE EXPECTED TO INCREASE BY 6 PERCENT.) THUS, THE DETERIORATION IN THE TERMS OF TRADE OF THE OECD WAS OF THE ORDER OF 12 PERCENT FOR 1974 AS A WHOLE, BUT AN IMPROVEMENT CAN BE ANTICIPATED FOR 1975 WITH THE CONTINUED RISE IN OECD EXPORT PRICES, STABLE OIL PRICES AND THE WEAKNESS OF NON-OIL COMMODITY PRICES.

10. IN SUMMARY, INTERNATIONAL TRADE HAS BECOME MORE THAN EVER A VEHICLE FOR THE INTERNATIONAL TRANSMISSION OF COST INFLATION, BUT HAS CEASED TO BE AN INSTRUMENT OF ECONOMIC GROWTH. AFTER A PERIOD OF GRACE, THE MAIN LOSERS FROM THESE CHANGES IN TRADE PATTERNS ARE THE NON-OIL LDCS, HIT SIMULTANEOUSLY BY THE TERMS OF TRADE AND BY WEAK WORLD DEMAND.

11. FINALLY, THE INCREASE IN OIL PRICES HAS CREATED DISTURBANCES ON DOMESTIC AND INTERNATIONAL FINANCIAL MARKETS. INITIALLY, ONLY A RELATIVELY SMALL PROPORTION OF THEIR HIGHER OIL PAYMENTS FOUND ITS WAY BACK INTO OIL CONSUMER COUNTRIES THROUGH INCREASING OPEC IMPORTS OR INVESTMENTS OF OIL FUNDS IN REAL ESTATE AND SECURI-

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TIES. THE DEFLATIONARY DEMAND IMPACT OF HIGHER OIL PRICES, THUS, WAS REINFORCED BY A CONTRACTIONARY EFFECT ON OIL CONSUMERS' DOMESTIC MONEY STOCKS (L). RECYCLING OF LIQUID OIL FUNDS THROUGH DOMESTIC AND INTERNATIONAL MONEY MARKETS TENDED TO RUN UP AGAINST SOME LIMITS TO THE BORROWING CAPACITY OF SOME OIL CONSUMERS AND THE LIMITED ABILITY OF THE INTERNATIONAL BANKING SYSTEM TO LEND TO OIL CONSUMING COUNTRIES, ON THE DESIRED LONGER-TERM BASIS, THE SHORT-TERM OPEC DEPOSITS. THE RECENT SHIFT OF OIL FUNDS INTO LONGER TERM FINANCIAL ASSETS HAS TENDED TO BE SOMEWHAT UNEVEN IN GEOGRAPHICAL ALLOCATION AND HAS SEEMED SOMEWHAT CONCENTRATED ON INDUSTRIAL "BLUE CHIP" STOCKS. DEFENSIVE CENTRAL BANK ARRANGEMENTS WHICH BACK UP THE LIQUIDITY OF THE INTERNATIONAL BANKING SYSTEM, AND THE SETTING UP OF OFFICIAL RECYCLING MECHANISMS WITHIN THE EEC, THE IMF AND THE OECD, SHOULD GO SOME WAY TOWARDS MITIGATING THE UNBALANCED LIMITED OFFICIAL USE

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FINANCIAL IMPACT OF THE REFLUX OF OIL FUNDS. HOWEVER, RAPID ACCUMULATION OF HIGHLY LIQUID OR MARKETABLE FINANCIAL ASSETS BY OIL PRODUCING COUNTRIES MAY CONTINUE TO ENTAIL FINANCIAL PROBLEMS, SINCE SHIFTS IN THE GEOGRAPHICAL DISTRIBUTION AND MATURITY COMPOSITION OF OPEC INVESTMENT PORTFOLIOS CAN PRODUCE UNDESIRABLE FLUCTUATIONS IN INTEREST RATES, SECURITY PRICES AND EXCHANGE RATES, IMPAIRING THE SMOOTH FUNCTIONING OF FINANCIAL MARKETS ON A WORLD-WIDE SCALE.

(FOOTNOTE (L) FOR AN ELABORATION OF THIS POINT CF. OECD ECONOMIC OUTLOOK NO. 15, JULY 1974, PP. 97-104.

## II LONGER TERM

12. IT REMAINS TO BE SEEN TO WHAT EXTENT THE SHORT-TERM LOSS OF OUTPUT AND THE UPSURGE IN THE WORLD PRICE LEVEL REPRESENT A CHANGE IN TREND. SO FAR AS INFLATION IS CONCERNED, IF THE RELATIVE PRICE OF OIL REMAINS UNCHANGED, THE ENERGY CRISIS MAY HAVE A ONCE-AND-FOR-ALL

EFFECT: UNLESS IT IS ASSUMED THAT INFLATIONARY EXPECTATIONS HAVE PERMANENTLY INCREASED, THERE SHOULD BE NO FURTHER ADVERSE IMPACT OVER THE MEDIUM TERM. THE SAME, HOWEVER, MAY NOT BE TRUE FOR OUTPUT, EVEN ASSUMING THAT OECD ECONOMIES REVERT TO FULL EMPLOYMENT LEVELS OF ACTIVITY. THE PRESENT RECESSION IS HAVING A DEPRESSIVE EFFECT ON INVESTMENT AND WILL THEREFORE LEAD TO A DECELERATION IN THE GROWTH OF THE CAPITAL STOCK IN PRACTICALLY ALL OECD ECONOMIES. THIS WILL, IN TURN, ENTAIL SOME SLOWDOWN IN THE EXPANSION OF MEMBER COUNTRIES' SUPPLY POTENTIAL.

13. A SECOND SOURCE OF SOMEWHAT SLOWER GROWTH COULD COME FROM THE EFFECTS OF THE SHIFT IN RELATIVE PRICES. THE HIGHER PRICE OF OIL WILL STIMULATE DEVELOPMENT IN THE OECD AREA OF ALTERNATIVE ENERGY SOURCES. THESE TEND TO REQUIRE RELATIVELY HIGH INPUTS OF CAPITAL FOR EACH UNIT OF OUTPUT. UNLESS NEW SAVINGS ARE FORTHCOMING, CAPITAL MIGHT HAVE TO BE DIVERTED FROM OTHER USES, IN WHICH ITS PRODUCTIVITY IS GREATER, TO THE DEVELOPMENT OF DOMESTIC ENERGY PRODUCTION. THE ORDERS OF MAGNITUDE INVOLVED IN BOTH THESE EFFECTS ARE, HOWEVER, RELATIVELY LIMITED OFFICIAL USE

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SMALL AND ANY DECELERATION IN LONGER-TERM GROWTH ARISING FROM THEM MAY REMAIN LIMITED.

14. THE SHIFT IN RELATIVE PRICES WILL ALSO ENTAIL OTHER CHANGES IN THE STRUCTURE OF DEMAND AND OUTPUT. IT CAN BE EXPECTED THAT THE WEIGHT OF INDUSTRIES WHICH CONSUME RELATIVELY LARGE QUANTITIES OF ENERGY WILL DECLINE, IN FAVOUR OF INDUSTRIES WHICH USE RELATIVELY LITTLE ENERGY. IN THE SHORT RUN, SUCH CHANGES MAY SOMEWHAT INCREASE THE LEVEL OF UNUTILISED CAPITAL AND UNEMPLOYMENT IN SECTORS IN WHICH DEMAND HAS DECLINED, WITHOUT NECESSARILY LEADING TO THE EXPANSION OF CAPACITY IN OTHER SECTORS BECAUSE OF RIGIDITIES IN THE TRANSFER OF PRODUCTIVE FACTORS. BUT OVER THE MEDIUM TERM, IT CAN BE EXPECTED THAT LABOUR AND CAPITAL SUPPLIES WILL ADAPT THEMSELVES TO THE NEW DEMAND STRUCTURE. HENCE THERE WOULD SEEM TO BE NO A PRIORI REASONS TO EXPECT ANY DECELERATION IN GROWTH ON THIS ACCOUNT, UNLESS THE CAPITAL OR LABOUR REQUIREMENTS OF THE NEW DEMAND STRUCTURE WERE RADICALLY DIFFERENT FROM THE OLD.

15. THE OIL PRICE INCREASE RAISES, HOWEVER, A MAJOR LONGER-RUN PROBLEM OF RESOURCE ALLOCATION. AS OPEC COUNTRIES GRADUALLY INCREASE THEIR DEMAND FOR GOODS AND SERVICES, THEY STIMULATE ACTIVITY IN THE OECD AREA, BUT, AT THE SAME TIME, THEY ABSORB A RISING PROPORTION OF OUR

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RESOURCES. THUS, THE SHARE OF OECD OUTPUT CLAIMED BY OECD RESIDENTS WILL HAVE TO DECLINE. GIVEN THAT THE SHARE OF DOMESTIC INVESTMENT AND OF GOVERNMENT SPENDING IN GNP MAY HAVE TO INCREASE (THE FORMER TO ACCOMMODATE THE REQUIREMENTS OF INCREASING ENERGY PRODUCTION, THE LATTER TO SATISFY THE INCREASING DEMANDS FOR SOCIAL SERVICES AND INFRASTRUCTURE), THE BRUNT OF THE ADJUSTMENT MAY HAVE TO BE BORNE BY HOUSEHOLDS. THIS COULD CREATE DIFFICULT PROBLEMS FOR DEMAND MANAGEMENT POLICIES, SHOULD CONSUMERS TRY TO FORESTALL TOO RAPID A DECLINE IN THEIR SHARE OF OUTPUT.

#### RESPONSIBILITIES OF VARIOUS COUNTRIES

16. IT WOULD SEEM INAPPROPRIATE TO ASCRIBE THE PRESENT DIFFICULTIES OF OECD COUNTRIES LARGELY TO THE OIL PRICE-



RISE. THEY WERE KEENLY AWARE OF THESE DIFFICULTIES -  
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AND CRITICAL OF THEIR OWN PERFORMANCES - PRIOR TO THE  
ACTIONS TAKEN BY OIL-PRODUCERS. IT IS, OF COURSE,  
UNDENIABLE THAT THE SIZE AND TIMING OF THE OIL PRICE  
RISE (WHICH FOLLOWED THE TEMPORARY DELIVERY RESTRIC-  
TIONS) AGGRAVATED AN ALREADY BAD POSITION, BUT IT IS  
PROBABLY MORE CONSTRUCTIVE, NOW, TO STRESS THAT INDUS-  
TRIAL AND OIL EXPORTING COUNTRIES HAVE A JOINT RESPONSI-  
BILITY IN RESTORING SUSTAINED AND SMOOTH GROWTH IN THE  
WORLD ECONOMY WITHOUT REKINDLING INFLATIONARY PRESSURES.  
THE OECD AGREES THAT LARGE MEMBER COUNTRIES WITH WEAK  
DOMESTIC DEMAND TRENDS BUT WITH THE BALANCE OF PAYMENTS  
AND INFLATION RELATIVELY UNDER CONTROL SHOULD FOLLOW  
EXPANSIONARY POLICIES TO REDUCE THE RISKS OF SERIOUS  
WORLD RECESSION. AT THE OTHER EXTREME, IT WOULD BE  
DANGEROUS FOR MEMBER COUNTRIES IN LARGE EXTERNAL  
DEFICIT AND STILL IN THE GRIP OF RAPID INFLATION TO  
MOVE BEFORE THEIR STRONGER PARTNERS. INDEED, THE FIGHT  
AGAINST INFLATION HAS TO BE PURSUED STRONGLY, STILL,  
BY MEMBER COUNTRIES. IN THIS CONTEXT, THE OIL EXPORT-  
ING COUNTRIES COULD MAKE AN IMPORTANT CONTRIBUTION IN  
TWO AREAS. A REDUCTION IN CRUDE OIL PRICES ACCOMPANIED  
BY AN ADEQUATE FLOW OF SUPPLIES COULD HELP TO RESTORE  
INTERNATIONAL PRICE STABILITY, ALLEVIATE THE PRESSURE  
ON THE BALANCE OF PAYMENTS OF NON-OIL LDCS AND THE  
WEAKER OECD COUNTRIES AND GENERALLY IMPROVE CONFIDENCE.  
FURTHER INCREASES IN AID BY OIL PRODUCERS AND MEMBER  
COUNTRIES TO NON-OIL LDCS WOULD RELIEVE THE ECONOMIC  
PROBLEMS OF THE LATTER, IMPROVE THE CURRENT ACCOUNT POSI-  
TION OF OECD COUNTRIES AND INCREASE WORLD DEMAND. AS  
REGARDS THE LONGER-TERM ISSUES, CONSTRUCTIVE CO-OPERA-  
TION BETWEEN INDUSTRIAL AND OIL EXPORTING COUNTRIES  
COULD GREATLY EASE THE PROBLEMS OF STRUCTURAL  
ADAPTATION IN THE WORLD ECONOMY.

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